Commitment 4: Comprehensive Pension Reform

City employees should receive a reliable retirement allowance that is no better and no worse than the average San Diego taxpayer – and city employees should assume a fair share of the risk and costs of these benefits.

Until the city reforms its pension liability, no tax increase will be big enough...no service cut will be deep enough...to satisfy the skyrocketing debt service on the city's pension system.

Like a bankruptcy reorganization plan, the Roadmap to Recovery is committed to restructuring and reducing our net liabilities in the pension system through reform of benefits for both existing and new city employees.

The reforms outlined in this Roadmap to Recovery are designed to reduce the long-term debt service on the pension liability and bring the city's long-term operating costs back down to sustainable levels. Specifically, the Roadmap to Reform is designed to produce a 20% reduction in the largest retirement cost faced by the city: the annual city payment for the defined benefit pension plan - and a reduction of one third of the cost of all retirement benefits.

When added together with reforms to other discretionary retirement benefits, the Roadmap to Reform not only achieves savings in the FY 2012 budget – but most importantly produces hundreds of millions of dollars in savings over the next 10-15 years.

All reforms outlined in this plan are legal – and have a well-documented and proven basis for implementation.

Modeling of Financial Impacts from Reforming Retirement Benefits

Analysis of the impact of retiree health care comes from actuarial data provided by the Buck Consultants for the "Joint Study" conducted by the city with input from the labor unions - as well as the city's 5-year Financial Outlook.

To model the financial impacts of a variety of pension reforms, Councilmember DeMaio's office obtained the services of a professional actuarial firm – Sheffer Consulting Actuaries, Inc.

It should be noted that the pension payments utilized in the Mayor's Five Year Outlook do not reflect the General Fund portion of the projections provided by the SDCERS actuary.[1] Our office has inquired as to the methodology utilized to obtain these pension projections on numerous occasions (e.g. budget hearing questioning, committee meeting questioning, written memoranda[2] and follow-up e-mail) but has not received an official explanation to date. As a result, the Roadmap to Reform uses the analysis provided by our actuary.

Reducing the Retirement Liabilities

Freeze Pensionable Pays

Sharing Investment Risks/Costs

Opt-Out Program

Managed Competition/Downsizing

Eliminate Retiree Health Care for Existing Employees

[1] See Five Year Financial Outlook, Attachment 1, Footnote 1. April 19, 2010.
[2] See Memo from Councilmember Carl DeMaio to Jay Goldstone. August 11, 2010.

The Five Year Outlook published in April of 2010 assumed a pay freeze in each year of the Outlook. Since we can only speculate that the pay freeze partially or wholly accounted for the variation between SDCERS and Five Year Outlook pension projections, we substitute the projections provided by our actuary for the projected pension payments in the Five Year Outlook to estimate baseline savings beginning in FY 2013.

FY 2012 Changes

Reform 4.1: Realize Savings from General Salary Freeze

As further explained in the long-term section of this Commitment, freezing payroll – particularly pensionable payroll – can have a significant impact on the City's annual pension payment. Recent experience has shown that the City can lower its annual pension costs by holding the line on salary increases. However, as the Independent Budget Analyst (IBA) has noted,

> *"For FY 2011, the pension system actuary…estimated the ARC reduction due to a one-year salary freeze to be approximately $8.6 million. This is less than the FY 2010 estimation of $12.0 million. The reason for the differ ence is that the City is only freezing general salary increases, and not the step increases that are received by classified personnel."*

Recognizing the issue raised by the IBA that is referenced above, we have also asked our actuary to estimate the impact of the pay freeze for the FY 2012 pension payment to account for the step increases that have occurred. Our General Fund estimate of the pay freeze impact is a savings of $8.1 million from the baseline projection in the Five Year Outlook.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City-Wide	Estimated value of reduced annual pension payment derived from general salary freezes	NA	$8,100,000

Reform 4.2: Eliminate Retirement Offset Contributions

The city's pension system was established on the contributory plan – wherein the employer (e.g. taxpayers) makes a contribution and city employees are supposed to make a substantially equal contribution for the normal cost of their pensions. Unfortunately, there are several areas where the spirit, of not the law, of "substantially equal" requirement are not being followed.

Within the budget, Retirement Offset Contributions "represent the amount of City employees' retirement contributions that the City pays" for the employee[3]. The Roadmap to Recovery requires that the City end the practice of "picking up" any portion of employee pension contributions in addition to the employer contribution.

While the City Council recently eliminated the offset for elected officials and unclassified/unrepresented employees[4], employees represented by the Municipal Employees Association (MEA) and Teamsters 911 still receive a retirement offset contribution.[5]

The Roadmap to Reform plan eliminates the offset entirely for all City employees to help move City employees closer to paying the Charter-required share of the cost of their retirement. This is projected to achieve a General Fund savings of $4.8 million based on the Adopted FY 2011 Budget ($7.9 million citywide).

The City Attorney has opined that eliminating the offset through the "Meet and Confer" process is legal, and recent precedent exists for doing so.[6] Furthermore, the City will be negotiating new MEA and Teamsters labor contracts to take effect in FY 2012.

[3] City of San Diego Adopted FY 2011 Budget.
[4] San Diego City Council meeting, October 19, 2010, Item 51
[5] Memorandum of Understanding with Municipal Employees Association, July 1, 2009.
[6] See City Atty Legal Opinion LO-2010-1.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City-Wide	Complete elimination of "offsets" to employee contributions for pensions	NA	$4.8 Million

Reform 4.3: Continue Savings Achieved from Revised SDCERS Rates for "Substantially Equal" Contributions

As our office and the City Attorney's office have raised the issue of challenging how the city achieves compliance with the Charter requirement of charging city employees a "substantially equal" share of the cost of a normal pension allowance, SDCERS has already taken some action that have resulted in benefits to city taxpayers.

In fact, the City's actuarial valuation results of June 30, 2009 were adjusted to reflect the Board's decision to adopt new employee contribution rates at its May 28, 2010 meeting. This resulted in a $2.6 million reduction in the FY 2011 ARC.[7]

Some on the City Council raised the possibility of "giving back" these gains; we do not support giving back these taxpayer savings. We expect additional savings in the FY 2012 budget from these modifications to contribution rates made by SDCERS, but are intentionally not scoring those savings pending further analysis of SDCERS methodology and its impact on FY 2012.

The Budget and Finance Committee should request this analysis as soon as possible so savings can be booked into the FY 2012 budget solution.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City Wide	Impact from "Substantially Equal" policy adopted for disability and other actuarial items	NA	Pending Analysis by SDCERS

Reform 4.4: Incorporate Reform of Rates Charged for Purchase of Service Credits Into FY 2012 Budget

Over the years city employees have been provided the opportunity to purchase additional service credits. After a legal judgment in favor of the City, SDCERS is in the process of correcting the practice described below, which incorrectly resulted in the City picking up the cost associated with employee purchases of service credits at prices below what they should have been.

On this issue, the city's Municipal Code section 24.1312 requires that:

> *"provides that an employee cost to purchase…[a] PSC must be the amount the Board determines to be both the employee and the employer (plan sponsor) cost for that service, SDCERS was not permitted by law to delay implementation of the new rates once it determined a new rate [in 2003]. The City ended up paying for the underfunding through it Unfunded Accrued Liability (UAL). As a result, the affected PSC contracts were not legally authorized…because SDCERS had no legal authority to continue to offer the old rates once it had determined that the new higher rates were required to comply with the Municipal Code. SDCERS is prohibited from requiring the City to make up the underfunded amount by including it in the City's UAL, and from permitting retirement benefits to be paid to members based upon contracts issued using the legally unauthorized rules."* [7]

In anticipation of savings from this legal ruling, the City underpaid the FY 2011 ARC by $4 million. This underpayment of the pension payment was not brought before the City Council, nor is the methodology (thus, appropriateness) used for calculating the $4 million underpayment known.

There are two issues to consider surrounding this underpayment:

1) If the underpayment is accurate, the City will have $4 million of appropriated funds from FY 2011 to carry over to FY 2012, assuming that the funds are not needed to bridge any FY 2011 budget gaps that may arise.

[7] SDCERS. "Summary: Court of Appeal Ruling on Purchase of Service Credit (PSC).

2) If the underpayment resulted in the City remitting an ARC payment that was too low, the City is accruing compound interest on that underpayment of 7.75% annually. Further, if SDCERS investment experience is favorable, the opportunity cost of not making the full pension payment increases.

Note: The proportion of the $4 million underpayment made to SDCERS that is attributable to the General Fund is unknown.

Given the financial condition that the City finds itself in and the potential for accruing interest owed to the pension system that would otherwise not be owed under a July 1 full payment scenario, we recommend that this issue be resolved as soon as possible at the Budget and Finance Committee.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City Wide	Impact from "Purchase of Service" rate adjustments by SDCERS	NA	Pending Analysis by SDCERS

Reform 4.5: Impact of Improved Investment Returns on Annual Pension Payment

It is our understanding that the pension plan administered by SDCERS exceeded the assumed rate of return for the year ending June 30, 2010. The precise magnitude of the impact will not be known until the actuarial valuation is complete at the end of calendar year 2010, however. The Five Year Outlook assumes that the FY 2012 pension payment is the result of all actuarial assumptions being achieved. Therefore, any positive net impact due to experience gains will lower the ARC payment in comparison to the projected payment in the Five Year Outlook, in turn lowering the FY 2012 deficit.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City Wide	Actuarial Impact from higher-than-expected investment earnings	NA	Pending Analysis by SDCERS

Reform 4.6: Complete DROP Cost Neutrality Study and Implement Necessary Reforms

One of the conditions in Prop D was the completion of a cost neutrality on the "Deferred Retirement Option Plan" (DROP) program. As part of the creation of DROP, the program was supposed to be implemented in a strictly "cost neutral" manner. Unfortunately significant questions remain on whether that has occurred over the life of this controversial program.

By July 1, 2011, the Mayor and City Council should complete the DROP study and implement any necessary reforms and adjustment to the DROP program or salaries of DROP participants to ensure full cost neutrality.

Reform 4.7: Reform Retiree Health Care Liability

In general, city employees hired before July 2005 are slated to receive free taxpayer funded health care coverage for life. This benefit has not been properly funded by the city as an employer or city employees - resulting in a massive unfunded liability.

The actuarial valuation for the City's retiree health care liability at June 30, 2009 revealed a funded ratio of only 3.05%, and an Unfunded Actuarial Accrued Liability (UAAL) of $1,317,880,746.[8]

Worse, city taxpayers face an ever-escalating liability due to the fact the city continues the practice of intentionally underfunding the cost of this benefit package. In FY 2011, the city's annual required contribution to service the current cost and future debt of this liability was over $120 million, yet the city only budgeted $57 million for this expense.

The Roadmap to Reform comprehensively reforms this debt facing taxpayers – and generates significant savings for taxpayers starting in FY 2012.

The Buck Study on Why the Retiree Health Care Liability Must Be Reformed

"The serious threat the unfunded liability is to the on-going viability of the current retiree health benefit;

"The major implications of the unfunded liability to the City's long term fiscal health; and

"The threat that the unfunded liability poses to reaching future agreements on satisfactory terms and conditions of employment."

The City has consistently under-funded the actuarially-determined payment for a retiree health care benefit that is the "highest level of retiree benefits in comparison to the jurisdictions in San Diego County," and "among the highest in comparison to the ten largest cities in the State of California."

Furthermore, "[t]he actuarial analysis conducted...reveals alarming numbers that the City and taxpayers will be required to pay if there are no changes to the current retiree medical benefit."

The Study goes on to note the following key point:

"Simply stated, the City believes it cannot sustain these numbers and maintain appropriate service levels to the public."

[8] Letter from Buck Consultants to City of San Diego re: GASB 45 Liability as of June 30, 2009.

Under the Roadmap to Recovery, we propose that the City implement "Option 12" modeled by Buck Consultants for the "Joint Study" conducted by the Joint Committee on Retiree Health.

This option freezes the City's retiree health contribution at $0 for current employees, while leaving the benefit unchanged for employees already retired.

Reforming retiree health care benefits in this manner is appropriate for two reasons. First, as already well documented, city employees impacted by this change can expect pension benefits "that are generous by any standard applied."[9] Those pension payouts can be used by these individuals to pay increased costs for health care.

Second, this reform has already been implemented for new employees. Safety Members hired after July 1, 2005, currently have no retiree health benefit. General Members hired after July 1, 2009 receive a modest defined contribution health care plan.

Without Retiree Health Care Reform, City Fiscal Outlook Is Bleak

The unfunded portion of the City's annual retiree health care payment represents part of the City's structural deficit, even if it is not acknowledged in the official deficit figure.

As a result, any reform of the retiree health care liability up to a level that reduces full annual costs (the ARC) to currently funded levels does not produce any real budgetary savings, per se. Such reform would significantly reduce what has been a relatively unrecognized component of the City's structural deficit, but does not help to balance the City's recognized budget deficit.

Past and current practice of underfunding the retiree medical benefit has perpetuated a generational inequity among taxpayers. By not adequately "pre-funding" retiree medical costs in previous years, the practice has forced today's taxpayer to foot the bill for the costs associated with providing yesterday's taxpayer with services.
The Joint Study explains this past practice, noting that:

> *"The City followed the custom of most other public entities in paying for retiree health benefits on an annual "pay-as-you-go" (PAYGO) basis...The PAYGO expense is the actual cost of providing retiree health benefits to all eligible retirees each year and does not include any amount to "pre-fund" the cost of paying this benefit in future years."*

Legal Authority To Implement Retiree Health Care Reforms

While the City Attorney has clearly opined on the limited options the City has to change pension benefits , the City has far more legal flexibility with regard to retiree health care.

The City notes in the Joint Study that "retiree health benefits are not part of the retirement system...such that a vote under Charter section 143.1 is no longer required to amend the retiree health benefit." Further, the City Attorney's office has noted the notion that "the retiree health benefit is an employment benefit subject to modification through the meet and confer process."

Further, the City Attorney's position "is supported by the recent decision of the Ninth Circuit Court of Appeals, San Diego Police Officers' Ass'n v. San Diego City Employees' Retirement System...in which the court reviewed the historical facts related to implementation of the City's retiree health benefit and determined that the benefit was a longevity-based benefit that has been treated as an employment benefit and that has been negotiated through the collective bargaining process."

To reiterate the ramifications of this point, the City Attorney's office has opined that "employment benefits are terms and conditions of employment, which may be modified or eliminated through the collective bargaining process..."

Comprehensive retiree health care reform must be viewed from the perspective of the City's finances in conjunction with other obligations of the City with respect to employee retirement benefits. Generous pension benefit multipliers have been deemed "vested rights" (unchangeable), but the City Attorney has made it very clear that the retiree medical retirement benefit can be changed.

[9] PRC Final Report, 2004

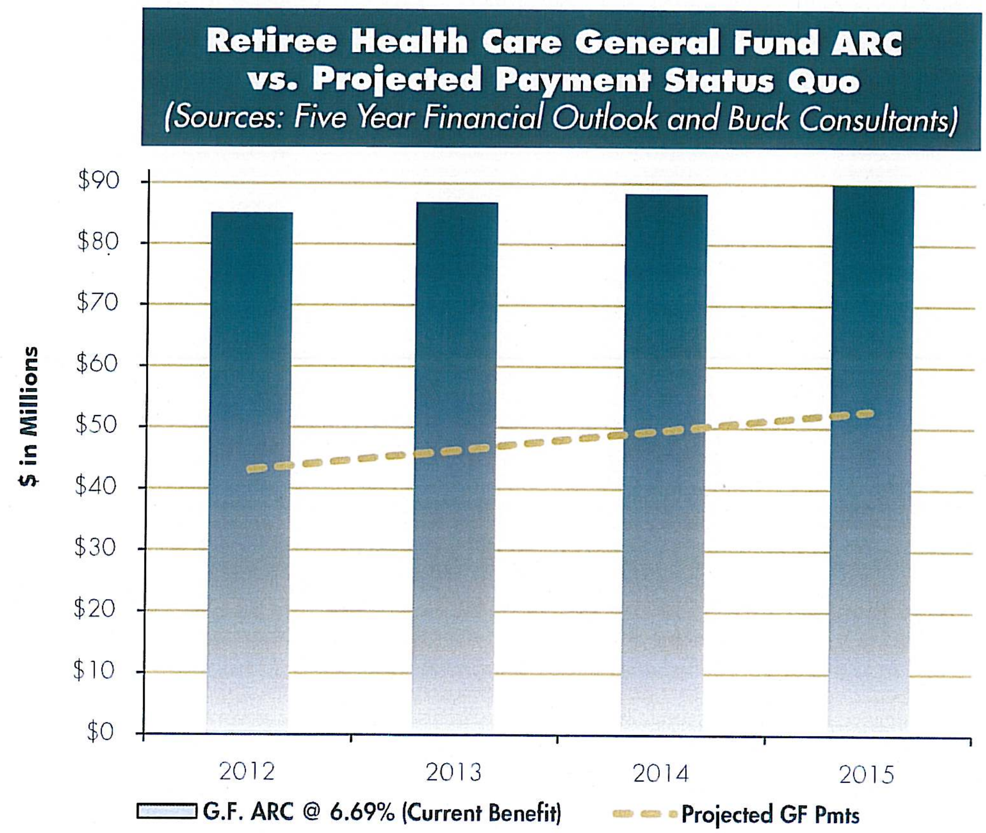
While the City began to pay expenses in addition to PAYGO costs ("pre-funding") in 2008, dealing with the unfunded liability associated with retiree health care has proven to be an unsustainable and massive drain on the City's finances, to the detriment of today's taxpayer. [10]

The Joint Study also depicts the detrimental impact that the retiree health care liability has on a sizeable portion of the City's workforce, noting that "...unions must also understand that the current retiree health benefit will preclude or substantially limit the City's ability to increase employee wages or benefits for the foreseeable future." (Emphasis added)

Budgetary Impact of Reforming Retiree Health Care

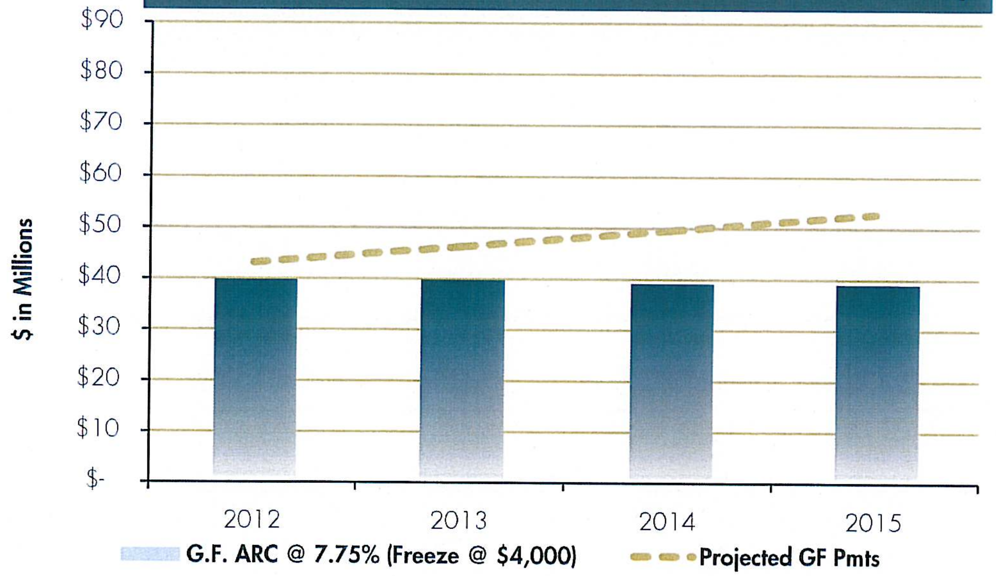
The reduction in General Fund retiree-health care expenses (thus, savings) in the General Fund can be seen in the charts below. The charts progress from the scenario projected in the Five Year Financial Outlook to a freeze of benefits at $4,000 per year, $1,000 per year, and $0.

In the "Status Quo" chart, the General Fund retiree health care payment is underfunded significantly in each year projected in the Outlook. The charts progressively show the budgetary savings available from reducing the benefit at various increments.



[10] See "FY 2011 Budget Recommendations and Priorities," May 20, 2010, and "Fiscal Analysis: Retirement Costs Consuming an Increasing Proportion of the General Fund." January 26, 2010.

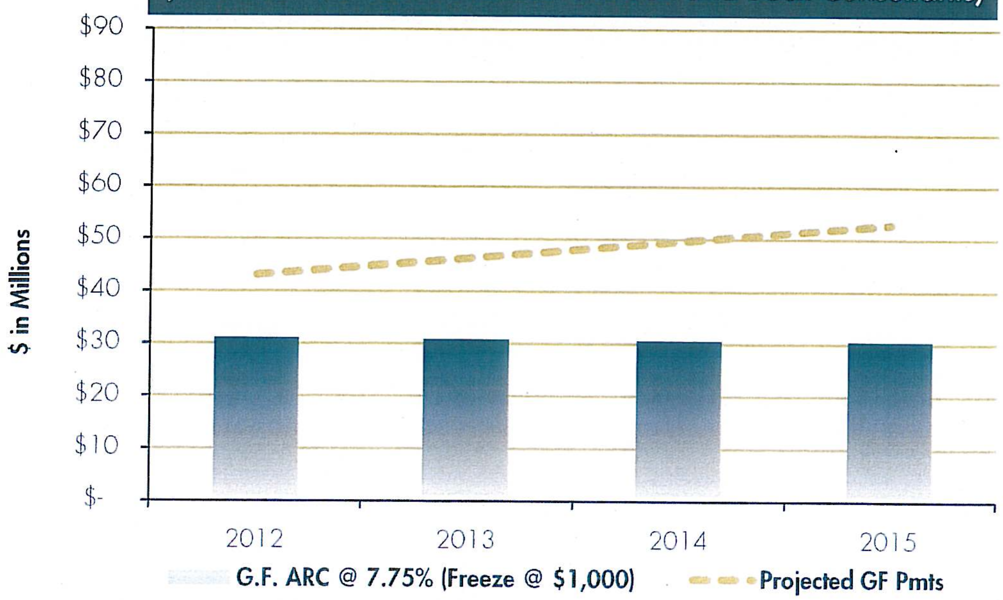
Retiree Health Care General Fund ARC vs. Projected Payment Freeze @ $4,000
(Sources: Five Year Financial Outlook and Buck Consultants)



The "Freeze @ $4,000" chart above shows the projected General Fund impact beginning in FY 2012 to retiree health care costs if the benefit is frozen at $4,000 for active employees. The City also benefits from a more favorable discount rate in "valuing the plan liabilities" with full funding of the ARC, "which results in lower accounting costs." [11]

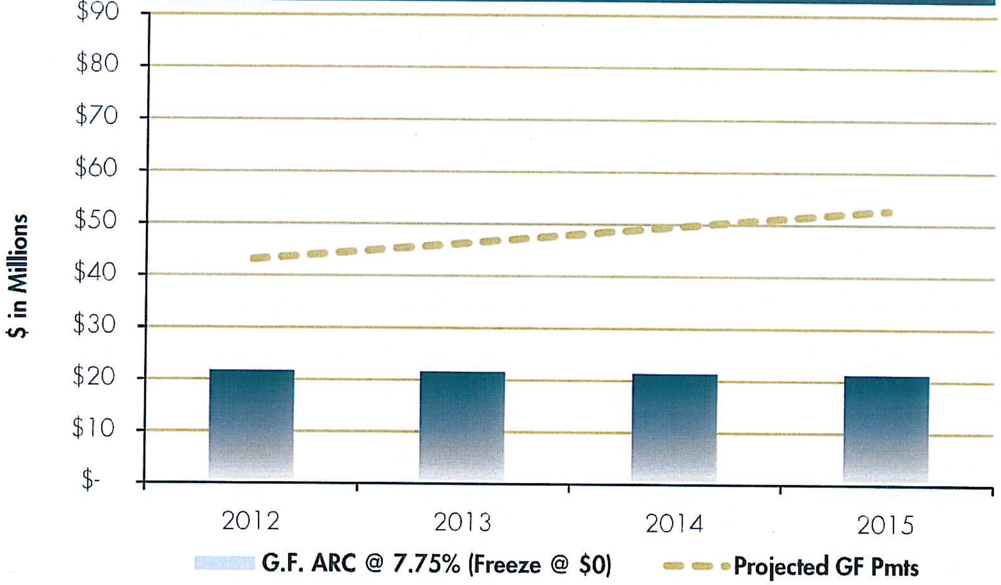
The charts below and the next page depict the increased budgetary savings from freezing the benefit for active employees at $1,000 and $0, respectively.

Retiree Health Care General Fund ARC vs. Projected Payment Freeze @ $1,000
(Sources: Five Year Financial Outlook and Buck Consultants)



[11] See Buck Consultants February 12, 2010 "Retiree Health Analysis for the Joint Retiree Medical Committee."

Retiree Health Care General Fund ARC vs. Projected Payment Freeze @ $0
(Sources: Five Year Financial Outlook and Buck Consultants)



Five Year Outlook Retiree Health Care Reform-Level Impacts				
Fiscal Year	2012	2013	2014	2015
Status Quo - General Fund Projected Payment vs. General Fund Portion of ARC				
ARC @ 6.69% (Underfund)	$85,312,111	$87,155,709	$88,779,931	$90,151,557
ARC @ 7.75% (Fully Fund)	$77,883,737	$77,486,505	$77,092,042	$76,700,346
Projected Pmt	$43,100,000	$46,300,000	$49,600,000	$52,800,000
Projected Underfunding	$42,212,111	$40,855,709	$39,179,931	$37,351,557
Projected General Fund Budget Savings from Reforms				
Freeze @ $4,000	($3,400,346)	($6,819,723)	($10,338,408)	($13,538,408)
Freeze @ $1,000	($11,885,467)	($15,264,014)	($18,740,484)	($22,116,263)
Freeze @ $0	($21,358,131)	($24,691,696)	($28,123,875)	($31,455,363)
Projected General Fund Structural Deficit Savings from Reforms				
Freeze @ $4,000	($45,612,457)	($47,675,433)	($49,518,339)	($50,889,965)
Freeze @ $1,000	($54,097,578)	($56,119,723)	($57,920,415)	($59,467,820)
Freeze @ $0	($63,570,242)	($65,547,405)	($67,303,806)	($68,806,920)

As the charts and data table above show, by reducing the retiree health care benefit to active City employees to $0, the City can reduce its projected budget deficit by $21.4 million in FY 2012. Just as importantly, however, is that the General Fund structural deficit can be decreased by $63.6 million through comprehensively reforming this liability.

City of San Diego Distribution of Safety (Fire and Police) Employees (as of 1/8/10)

Years of Service	0-4	5-9	10-14	15-19	20-24	25-29	30+	Total
# of Employees (Fire)	198	186	151	106	126	91	7	865
% of Total (Fire)	22.9%	21.5%	17.5%	12.3%	14.6%	10.5%	0.8%	100.0%
# of Employees (Police)	563	240	238	336	322	144	25	1868
% of Total (Police)	30.1%	12.8%	12.7%	18.0%	17.2%	7.7%	1.3%	100.0%

Source: City of San Diego Retiree Health Joint Study, Appendix

The City table above and the preceding statement regarding the retiree health benefit for safety members indicates that approximately 23% (more than one in five) of firefighters and 30% (more than one in four) of police officers are impacted by the benefits awarded to their counterparts with more years of service that they themselves cannot receive.

In essence, the generational inequity associated with retiree health care does not only apply to taxpayers, but to a significant segment of City employees. The same metric is provided for the citywide workforce below, although it should be noted that post-2009 general members participate in a .25% defined contribution retiree health plan. As the table shows, more than 20% of the entire City workforce does not stand to benefit from any continued dispute over retiree health benefits, while at the same time these employees' ability to earn salary increases is being sacrificed due to the incredible pressure placed on City finances by the current benefit.

City of San Diego Distribution of Active Employees (as of 1/8/10)

Years of Service	0-4	5-9	10-14	15-19	20-24	25-29	30+	Total
# of Employees	2046	1898	1574	1501	1409	570	235	9233
% of Total	22.2%	20.6%	17.0%	16.3%	15.3%	6.2%	2.5%	100.0%

Source: Appendix to the City of San Diego Retiree Health Joint Study

To recap, eliminating the benefit for current employees provides the following benefits to the City financially:

It represents a legal means to reduce overall retirement packages afforded to current City employees to more sustainable levels in a way that is different from the City's ability to affect pension benefits.

It achieves significant annual General Fund budget savings.

It reduces one of the somewhat unrecognized components of the City's structural budget deficit by an even greater amount.

It helps to undue a generational inequity imposed on taxpayers because the benefit was not funded adequately in the past.

It helps to eliminate a generational inequity currently imposed on approximately one-fifth of the City's work force (more than one-fourth of police and fire employees) by removing a significant impediment to the City's ability to increase salaries for the foreseeable future.

Departmental Budget	Line Item	FTE Impact	General Fund Savings
City Wide	Retiree Health Care Reform	NA	$21,358,131

Long-Term Changes

Reform 4.8: Reduce and Freeze "Pensionable Pay" for Five Years

While the City is limited in its options to change pension benefits for existing employees, it does have control over annual salaries and wages through the negotiating process. The City Attorney has opined: [12]

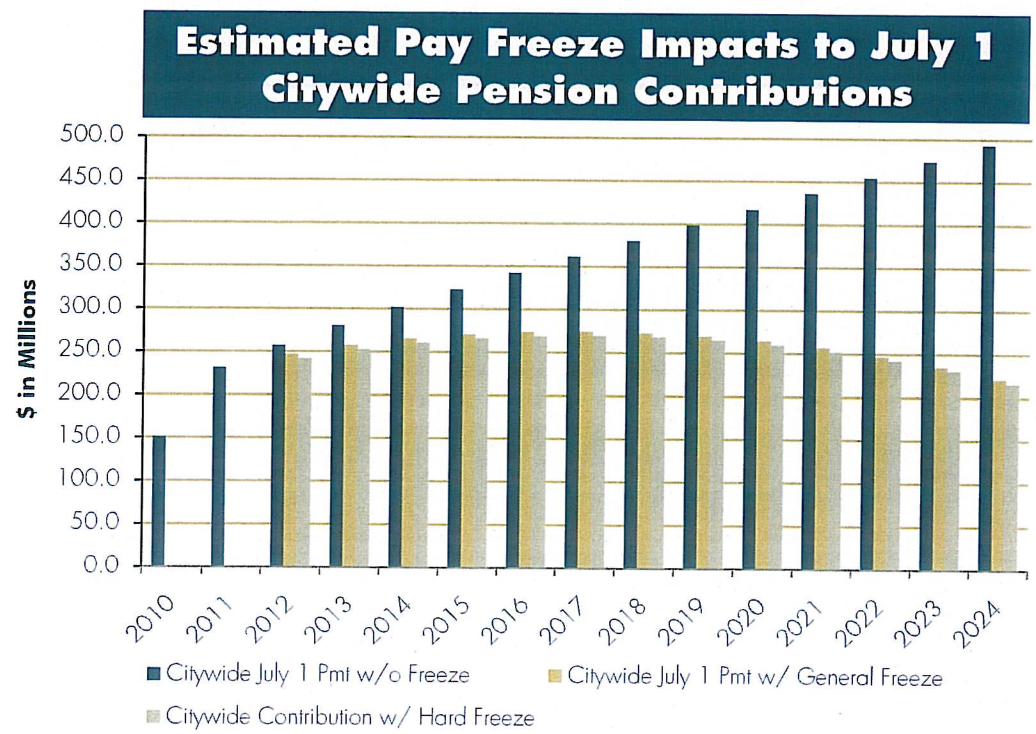
> *"As a general rule, the terms and conditions of public employment are governed by statute or ordinance rather than by contract, and employment benefits, including compensation, may be modified or reduced as long as the City complies with any applicable procedural requirements."*

We obtained a model of a "hard" pay freeze – one that assumes that payroll is held constant in each year. It is important to note that the City has maintained the practice of awarding "step" increases as called for under Personnel Regulations.[13] As explained in Reform 4.1, the City can achieve over $8 million in savings in FY 2012 from the prior general salary freezes.

While the City could propose temporarily freeze step salary increases in negotiations, such a proposal could be more difficult to attain in the "Meet and Confer" process than other labor cost savings (for example, a general salary freeze or reduction) because of legal issues created by Charter section 130 (additional information provided in the "Step Increase Freeze" section below). As a result, in our FY 2012 recommendations, we focus on general salary cuts and various options for cost savings with special pays.

The graph to the right shows the range of estimated impacts from implementing an indefinite pay freeze. We are not suggesting that pay be frozen through FY 2024, but provide the analysis to display the ability the City has through a freeze to impact its annual pension payments.

The "General Freeze" is an estimate that accounts for step increases, while the "Hard Freeze" shows the estimated impact to City pension payments from holding pensionable payroll at a truly frozen level. [14]



[12] See City Attorney Opinion Number 2010-1.
[13] See Personnel Regulations Index Code H-8.
[14] Pension projections are based on data from the original June 30, 2009 SDCERS Actuarial Valuation, published in January 2010. A revised version of the valuation was released after our actuarial firm had begun their work. The data we have been provided assumes mid-year contributions by the City. To account for the City's practice of making its full ARC payment on July 1 of each year, we adjust mid-year payment projections for interest savings by the following formula: July 1 ARC = Mid Year ARC * (1 – (.0775/2)). The General Fund portion of the payment is assumed to be 77.8% each year, per the most recent Five Year Financial Outlook.